DESERT SCHOOLS
FEDERAL CREDIT UNION

May 20, 2014

Mr. Gerard Poliquin
Secretary of the NCUA Board
1775 Duke St
Alexandria, VA 22314

Re: Comments on Proposed Rule: Prompt Corrective Action – Risk Based Capital

Dear Mr. Poliquin:

Please accept this letter as Desert Schools Federal Credit Union's ("Desert Schools") formal comment on the National Credit Union Administration's ("NCUA") recent proposed rule, Prompt Corrective Action – Risk-Based Capital issued on January 23, 2014. We appreciate the opportunity to share our comments and recommendations regarding this proposed rule with the Agency. Desert Schools is based in Phoenix, Arizona and has 308,000 members, $3.8 billion in assets and 48 branches.

First and foremost, Desert Schools commends the NCUA for taking what it views as a positive first step toward improving the existing risk-based net worth standard. However, we believe the Proposed Rule as it is currently drafted imposes unduly harsh capital requirements on credit unions and places us at a severe competitive disadvantage to banks. In this comment letter, we primarily explore what we consider the major areas of concern in the Proposed Rule and provide our recommendations for improvement of those areas.

POSITIVE ASPECTS OF THE PROPOSED RULE

The Proposed Rule addresses some of the weaknesses with the current prompt corrective action net worth ratio structure. Specifically, Desert Schools would like to highlight the following positive aspects of the Proposed Rule which we support:

a. Attempting to measure capital in a more consistent manner with the other financial regulators in the United States;
b. Recognizing that all assets are not of equal risk;
c. Assigning different risk-weights to current versus delinquent loans;
d. Attempting to minimize reporting/regulatory burden by using existing Call Report data; and
e. Capturing the risk of off balance sheet items.

OPPORTUNITIES FOR IMPROVEMENT OF THE PROPOSED RULE

The following focuses on areas of the Proposed Rule which are extremely troubling to Desert Schools and which we would like to see removed or modified:

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1. Credit unions, by law, regulation and structure, maintain lower risk balance sheets than banks and should be recognized for this in the applicable capital retention requirements; however, this is not the case under the Proposed Rule. The Basel Committee on Banking Supervision's capital standards (collectively referred to as "Basel") for community banks appear to have a more favorable outcome then the standards outlined in the Proposed Rule. If we apply those to Desert Schools' current balance sheet, Desert Schools has a considerably better risk-based capital ratio than under the Proposed Rule's current requirements. We recommend that NCUA's standards better align with those used by Basel for community banks.
2. Risk-weights for some investment categories appear to be excessive and punitive. They should be changed to be more consistent with Basel.
3. There is an attempt to capture interest rate risk in the calculation through investments; however, no consideration is being given for the liability side of the balance sheet.
4. Cash held at the Federal Reserve should have the same risk-weight as under Basel for community banks (0%).
5. The NCUSIF deposit should not be a deduction from the risk-based capital numerator.
6. The effective date should be extended with shorter periodic steps required, similar to the Basel timeline (see discussion of Effective Date below).
7. Prompt corrective action should only be instituted if a credit union falls below an adequately capitalized level similar to what Basel requires.
8. The concentration risk penalty for first mortgage loans and other real estate loans should be eliminated.
9. Investments in Credit Union Service Organizations ("CUSOs") should have similar risk-weights as Loans to CUSOs.
10. The risk-weighting proposed for Mortgage Servicing Assets is not appropriate for those credit unions that have invested the resources to manage the underlying interest rate risk.
11. The allowance for any examiner discretion regarding establishing individual minimum capital ratios should be eliminated from the Proposed Rule because it would be virtually impossible for the Agency to apply this standard in a consistent and fair manner across all credit unions. In addition, no such provisions exist under Basel.
12. The section related to 'comprehensive understanding' of 'asset-backed investments', including the 1250% risk-weight, should be eliminated or revised significantly.
13. NCUA should increase the amount of ALLL permitted in the risk-based capital numerator given the high probability of FASB implementing its recent proposal on ALLL (the Current Expected Credit Loss model).
14. The Proposed Rule, as it stands, would require substantially more capital for a credit union than a bank with a similar risk profile. This would put credit unions at a clear competitive disadvantage.
15. The Proposed Rule, as it stands, has the potential to create perverse incentives to increase credit risk, while attempting to reduce perceived interest rate risk.

16. The Proposed Rule is a complete overhaul of current credit union capital standards, thus it would be appropriate to incorporate a supplemental capital provision into the regulation and put it out again for further public comment.

SECTION-SPECIFIC COMMENTS

In the following sections (in order by section number), we have highlighted in more detail the more problematic aspects of the Proposed Rule.

Section 702.104(b)(1) Capital Elements of the Risk-Based Capital Numerator:

The Proposed Rule allows the ALLL to be included in the risk-based capital numerator with the limitation up to 1.25% of risk-weighted assets. This would be appropriate; however, FASB's most recent proposal on ALLL (the Current Expected Credit Loss model), if put into place, has the potential to significantly increase ALLL reserves, up to 50% or more. Given the fact that both FASB and regulatory agencies are in agreement on the Current Expected Credit Loss model, there is high likelihood that some form of this proposal will be implemented in the near future (before the Proposed Rule would take effect).

Recommendation

Based upon the high probability that the Current Expected Credit Loss model will be implemented, the limitation of 1.25% of risk-weighted assets should be eliminated from the Rule.

Section 702.104(b)(2) Risk-Based Capital Numerator Deductions:

The Proposed Rule deducts the NCUSIF deposit from the risk-based capital numerator. The NCUA states "The proposed rule would address concerns about the NCUSIF deposit reflected on the NCUSIF's balance sheet both as equity to pay losses and as an asset of the insured credit unions. In the proposed rule, the NCUSIF deposit is subtracted from both the numerator and denominator of the risk-based capital ratio. This treatment for the risk-based regulatory capital standard would not alter the NCUSIF deposit accounting treatment for credit unions."

It is not clear as to what the NCUA's intent is regarding the NCUSIF deposit. Desert Schools interprets this section as somehow trying to make the numerator similar to banks, in that, they expense their insurance premiums as they pay them on a quarterly basis. The flaw in this methodology is the fact that banks do not have a deposit held at the FDIC, but rather pay a quarterly premium that is non-refundable.

There are many scenarios under which a credit union could have its NCUSIF deposit returned such as: conversion to a mutual savings association, election of private insurance rather than NCUA coverage or voluntary liquidation. GAAP recognizes this deposit as an asset; therefore, it does not make sense to treat the deposit as an intangible asset given that it is easily measured and can be returned or refunded.

It is clear that banks and credit unions differ as to how they pay insurance premiums; however, the end result is similar. The fact that a credit union's deposit is held in a non-interest bearing account illustrates the true opportunity cost or premium, similar to a bank.

Recommendation

The NCUSIF deposit should not be deducted from the risk-based capital numerator or the risk-based asset denominator.

It is recognized that the deposit would be lost if a credit union were to fail and thus reduce its capital; however, the deposit is held in the NCUSIF for that purpose and it can be attributed to the failed credit union. The deposit is under NCUA's control and it is supplementary to the capital available on a credit union's books in case of failure. Therefore, it should remain part of the risk-based capital numerator.

The risk of loss to this asset is minimal given the fact that it is under the NCUA's control, again supporting the notion that the risk-weight should be zero.

<u>Section 702.104(c)(2) Risk-Weights for On-Balance Sheet Assets</u>

Investments:

The proposed risk-weights for investments are very troubling. The proposed measurements are inconsistent across the different investment options, provide incentives to carry higher risk assets, place credit unions at a competitive disadvantage to other federally-insured financial institutions and fail to meet the stated goals of the Proposed Rule as discussed in more detail below.

In its Section-by-Section Analysis, the NCUA states: "The Board believes the change in methodology would improve the comparison of assets and risk-adjusted capital levels across financial institutions. Use of a consistent framework for assigning risk-weights would promote improved understanding between all types of federally insured financial institutions." We believe the Proposed Rule fails to meet this stated goal based upon the facts outlined in this section.

An area of major concern is the highly punitive nature of risk-weights applied to investments in the Proposed Rule. Using NCUA's online calculator, Desert Schools' risk-based capital ratio for March 31, 2014 was 11.21%, just enough to be considered well-capitalized. In contrast, if we were to use the Proposed Rule but substitute the risk-weights used by U.S. banking regulators for similar investments, Desert Schools' ratio would more than double to 24.77%. As can be seen, this variance is very large. It is difficult to believe that a reasonable comparison between all types of federally-insured financial institutions can be completed with this large of a difference.

The Proposed Rule's proposed risk-based capital ratio may have far reaching consequences on how Desert Schools operates, including:

- Limit growth and merger opportunities;

- Skew investment strategy without concern for the rest of the balance sheet;
- Create the need to raise additional, potentially unnecessary capital; and
- Reduce returns to members along with the overall value of Desert Schools.

Risk-based capital will be a go-to standard for measuring risk by many parties, including: examiners, Board members, creditors and other third parties. As proposed, this rule could have serious negative consequences for Desert Schools as outlined in the previous bullet points.

Consistent with the banking risk-based capital standards, the methodology for risk-weighting most asset categories in the Rule is primarily based upon credit risk, including the loan portfolio. While concentration risk is considered in certain types of loans and adjustments are proposed, concentration risk is a sub-component of credit risk. While the NCUA states that it has given consideration to other types of risk (credit, concentration, market interest rate, operational and liquidity) in the Proposed Rule, there is little evidence of measuring any risks other than credit risk for any significant classes of assets with the exception of certain investments cited below.

Credit risk and interest rate risk are the main drivers for risk-weightings for investments. Credit risk is the driver for investments in overnight funds lent to other counter-parties, corporate credit union capital and CUSO capital as well as investments unconditionally guaranteed by the U.S. Government. The risk-weights for other types of investments appear to be based primarily on simplistic interest rate risk guidelines. This creates an extreme inconsistency between asset classes as well as failing to meet the NCUA's previously stated goals of comparability of risk-adjusted capital levels across financial institutions and a consistent framework for assigning risk weights between all types of federally insured institutions. The fact that Desert Schools' risk-based capital ratio would be negatively impacted by 1356 basis points versus Basel standards for community banks is a compelling example of this lack of comparability.

The risk-based capital methodology that is the basis for Basel III is based almost exclusively on credit risk. This is reasonable and appropriate given the overwhelming majority of financial institution failures that result from credit risk or some other risk brought about because of credit risk. While many financial institutions failed during the housing crisis from a lack of liquidity, the failures were primarily brought on due to credit risk.

It appears as though the NCUA is trying to build a risk-based capital standard based upon their concern of rising interest rates and the interest rate risk that will accompany such rate increases. As previously stated, the overwhelming majority of failures occur because of poor management of credit risk. In fact, very few financial institutions fail due to interest rate risk. Even going back to the savings and loan crisis, while interest rate risk was part of the problem, the genesis of those events were rooted in regulatory deficiencies, credit risk, fraud, insufficient capital to begin with, and management inexperience.

NCUA states in the Section-by-Section Analysis: "The design of the risk-based net worth requirement should reflect a reasoned judgment about the actual risk involved." Using Desert Schools' risk-based capital ratio (11.21%) under the Proposed Rule and comparing that to our capital ratio using investment risk-weightings from Basel (24.77%), we struggle to see the reasonableness with that large of a discrepancy.

According to the Proposed Rule, "The current risk-weights for investments relied on the results of 300-basis point interest rate 'shock tests' to corroborate the assigned risk-weights. The 300-basis point shock test is a widely accepted measure of interest rate risk." By only trying to capture interest rate risk in one area of the balance sheet, the Proposed Rule conflicts with interest rate risk management methodology by not taking the entire balance sheet into consideration. Interest rate risk can only be measured effectively by measuring all assets and all liabilities (e.g., investments, loans, deposits, wholesale funding, off-balance sheet items, etc.). Therefore, Desert Schools' position is that it would be inappropriate to implement a risk-based capital plan that has the threat of prompt corrective action with such a narrow view of interest rate risk management.

The Federal Reserve recently published stress test results for the largest financial institutions in the United States (>$50 billion in assets)[1]. These stress tests included a 300-basis point shock test as one of the major assumptions. The tests are intended to illustrate whether a financial institution will maintain capital adequacy (5% tier 1 capital ratio) under hypothetically rigorous conditions. We find it unusual that the NCUA would propose a baseline (not a stress test) risk-based capital standard that is rooted in a 300-basis point interest rate shock test and require 10.5% to be considered well capitalized.

There are inconsistencies in the proposed risk-weights, not only when compared with risk-weights of other asset classes such as loans, but also when comparing different investment classes. Examples are listed below:

a. A current, 30-year conventional residential mortgage held in portfolio (assuming the portfolio represents < 25% of total assets) would receive a risk-weight of 50%. However, that same loan sold to Fannie Mae and then purchased as part of a 30-year, current coupon, TBA agency mortgage-backed security would be risk-weighted at 150%. Each instrument has effectively the same amount of interest rate risk, but the mortgage-backed security has an effective risk-weight three times higher, despite the fact that a mortgage-backed security has no credit risk. That same 30-year loan sold to FHA carries a risk-weight of 20%. While it makes sense that the risk-weight of an FHA-guaranteed loan is less than a 30-year conventional mortgage held in portfolio, it is hard to understand why it has a risk-weighting of 7.5 times less than an agency mortgage-backed security. In essence, agency mortgage-backed securities are unfairly punished versus FHA or first mortgage loans.

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[1] http://www.federalreserve.gov/newsevents/press/bcreg/ccar_20140326.pdf

b. A current, member business loan with a 7-year balloon maturity (assuming the portfolio represents < 15% of total assets) would carry a risk-weight of 100%. A 7-year agency bullet (Fannie, Freddie, FHLB) would carry a 150% risk-weight. Each instrument has about the same amount of interest rate risk; however, the agency bullet has substantially less credit risk than the member business loan. Again, this application of the Proposed Rule seems inconsistent.
c. Under the Proposed Rule, debt unconditionally guaranteed by the U.S. Government, such as a 30-year Treasury bond would have a risk-weight of 0%. Under a 300-basis point shock test, a new issue 30-year Treasury bond could lose up to 40% of its original value. Compare this to a 30-year, current coupon, TBA agency mortgage-backed security with a risk-weight of 150%. The mortgage-backed security would lose up to 25% of its value in a 300-basis point shock test in comparison to up to 40% for the 30-year Treasury bond. Although 30-Year Treasury, bonds have extreme levels of interest rate risk, the NCUA can't imply risk associated with U.S. government debt so they assign a risk-weighting of 0% while an agency mortgage-backed security has a risk-weight of 150%. Historical principal loss ratios are equal for both instruments. This is another example where the application of the Proposed Rule seems to be terribly inconsistent.
d. As we interpret the proposed rule, debt unconditionally guaranteed by the U.S. Government, such as a 30-year, current coupon, Ginnie Mae mortgage-backed security would be risk-weighted at 0%. Compare this to 150% for a Fannie Mae or Freddie Mac mortgage-backed security. Each security has the same amount of interest rate risk; in fact, the Ginnie Mae security may actually have a little more cash flow volatility. Further, no investor has ever lost principal from a Fannie Mae or Freddie Mac mortgage-backed security investment. So in essence, the two structures have similar interest rate risk and credit risk characteristics yet the risk-weightings are either 0% or 150%.
e. General obligation municipal obligations carrying credit ratings of AA or AAA have a loss ratio of less than 1 basis point over the last 30 years are given much higher risk-weights when compared to loans with similar average lives or even Treasury debt with far longer maturities.
f. Private label asset-backed securities as compared to agency–backed, mortgage-backed securities are given the same risk-weight for similar average lives. This is inconsistent because private label securities are much more complex and carry credit risk. Our position is that private label asset-backed securities should have much higher risk-weightings than agency securities.

The Proposed Rule seems to favor one specific interest rate scenario (i.e. increasing rates) rather than considering the probability that interest rates could move up or down in a non-parallel fashion. The Proposed Rule is written in such a way that it only contemplates the current interest rate environment without considering what it will look like once interest rates have risen to a more normal environment where the probability of interest rates moving up or down is roughly 50/50. By the time the Proposed Rule becomes fully implemented, it is likely the economy will be in a more normalized interest rate environment and the NCUA should consider the unintended consequences of the Proposed Rule in that environment. Due to the heavier risk-weights assigned to portfolios with longer average lives, many credit unions will naturally keep shorter duration portfolios. The short, weighted-average life investment portfolio will not perform very well under many scenarios, especially when rates move lower. Further, the narrow view of this interest rate risk calculation doesn't take into consideration the liability side of the balance sheet. Risk on the asset side of the balance sheet is calculated with no attempt to credit any risk offset from deposits, borrowings, and off-balance sheet holdings. This is particularly troubling for any institution with borrowed funds on their balance sheet because while borrowings provide a substantial amount of interest rate risk protection in a rising rate environment it is not recognized at all under the proposal. We view this as one of the major limitations of the Proposed Rule.

Another negative impact of trying to capture interest rate risk through weighted-average lives is the volatility that it will create in the risk-based capital ratio. With a loan to share ratio of 43%, Desert Schools has no choice but to manage an investment portfolio that includes several asset classes that are spread across different weighted-average life buckets. Desert Schools currently manages this by keeping a close eye on our concentration risk, liquidity risk, and interest rate risk as measured through the entire balance sheet. As interest rates change, it is expected that the average lives of our investments will change; however, the Proposed Rule intimates that somehow that is bad and Desert Schools should hold more capital because of it.

An attempt to limit interest rate risk primarily through a portion of the investment portfolio as reflected in the Proposed Rule will not work effectively. Rather, the Proposed Rule will:

- Create inconsistent treatment of different types of investments;
- Create inconsistent treatment of investments and loans;
- Create volatility in the risk-based capital ratio;
- Provide incentive for credit unions to carry assets with more risk; and
- Place credit unions at a competitive disadvantage with banks while failing to meet the stated goals of the Rule.

Recommendation

Adopt the risk-weights for investments applied to federally-insured financial institutions as consistently used by all other financial institutions in the United States. Rather than using divergent and inconsistent risk-based capital measures, create regulatory governance of interest rate risk through existing, more comprehensive NCUA guidance rather than attempting to regulate interest rate risk by looking at only one portion of the balance sheet.

The benefits of applying a risk-weighting regime similar to what financial institutions follow are:

1. *Risk-based capital measurements more consistent and comparable with other financial institutions, thus, meeting one of the NCUA's intended goals.*
2. *Methodology between loan and investment classes is more consistent as to not incent riskier behavior to manage risk-based capital.*

3. *Appropriate and less punitive risk-weights for investments.*
4. *Avoid unintended consequences to credit unions in a 'normal' interest rate environment.*
5. *Less volatility in risk-based capital.*
6. *Avoid unnecessarily requiring too much capital for credit unions.*
7. *Put credit unions on a more level playing field with other financial institutions.*

While adopting the investment risk-weighting of all other federally-insured financial institutions may cause increased regulatory reporting, the result will be consistency and accuracy across the financial institution industry. The benefit clearly outweighs the burden.

Cash (Held at the Federal Reserve):

All cash on deposit, irrespective of where it is held, currently has a proposed risk-weighting of 20%. This holds true for reserves held at the Federal Reserve which is in contrast to the 0% risk-weight that other financial institutions enjoy.

The proposed risk weight for reserves at the Federal Reserve would negatively affect our risk-based capital ratio by 84 basis points in comparison to other financial institutions under Basel.

Recommendation

Reserves held at the Federal Reserve should have a risk-weight of 0%, bringing them in line with other financial institutions and reflecting the true risk of the reserves.

First Mortgage Real-Estate Loans (Excluding Commercial Real Estate):

Historically, first mortgage loans have been a stable, low credit risk asset and a primary asset for a credit union's presence and mission in their communities. It is important to acknowledge the significant losses credit unions have incurred during the housing crisis and the significant progress that has been made since in underwriting and risk mitigation. High-risk mortgages currently make up very little of the loan production of credit unions. New legislation, such as the Dodd-Frank Act, and the creation of the Consumer Financial Protection Bureau have changed the mortgage industry landscape by reducing the probability of questionable underwriting in the future that could cause extensive losses and repeat the recent market turmoil.

A down side to the increase in regulation is the increased burden and costs to originate a qualified mortgage. The Proposed Rule would exacerbate the burden and costs by requiring higher levels of capital for those credit unions that hold first mortgage assets in excess of 25% of total assets. The increased capital cost based upon concentration risk puts credit unions at a competitive disadvantage to other financial institutions that do not have higher risk-weighting for concentration of loans.

Recommendation

Eliminate the higher risk-weights for concentrations of residential first mortgage loans. Credit unions and their members will both benefit by not increasing their costs to fund these loans and credit unions will not be at a competitive disadvantage to other financial institutions.

Other Real Estate Loans:

As the housing market continues to recover, second mortgages are becoming an important financial tool for homeowners to use. This loan category has been a historically good performer, excluding the most recent period which saw underwriting standards slip to levels not seen before. Similar to first mortgages, the concentration component above 10% of total assets for second mortgages puts credit unions at a competitive disadvantage to other financial institutions that do not have higher risk-weighting for concentration of loans.

Recommendation

Eliminate the higher risk-weights for concentrations of other real estate loans, including second mortgages. This will ensure that credit unions will not be at a competitive disadvantage to other financial institutions.

Investments in CUSOs:

CUSOs promote collaboration and risk sharing within a credit union structure and have been largely successful over the years. While there have been some losses since 2008 in CUSOs (approximately $200 million according to Chairman Matz), these losses pale in comparison to the fact that credit unions have charged off almost $30 billion in total loans, written off another $5 billion in conserved corporate credit union capital, and contributed $4.8 billion in TCCUSF assessments over the same time period.

CUSOs are proposed to have a risk-weight of 250% irrespective of the type of business that is conducted by a particular CUSO. Given the range of services that a CUSO can perform (and inherent risk associated with that service), this risk-weight seems arbitrary and punitive depending on the type of service provided by a CUSO. For example, a CUSO specializing in member business loans would typically have a higher risk profile than an investment services CUSO and certainly more risk than a CUSO that supports the back office.

Another deficit of the CUSO risk-weight proposal is that the 250% risk-weight is based upon current value of the CUSO investment, rather than the initial investment, thus penalizing growth (or success) in investment value.

Recommendation

Bring the risk-weight in line with Loans to CUSOs (100%) under the Rule and only apply the risk-weight to the original investment amount in the CUSO. This would be much more consistent with the *inherent risk of the investment and serve not to penalize success of the CUSO. Further, the NCUA board recently passed the final CUSO regulation which authorizes them to regulate the investments and loans a credit union makes to a CUSO. This enhanced authority supports a lower risk-weight.*

Mortgage Servicing Asset ("MSA"):

MSAs are proposed to have a risk-weight of 250%. MSAs have become a larger portion of credit union balance sheets over the last few years because interest rates remained at levels that made it challenging to hold 30–year, fixed rate mortgages on balance sheet due to interest rate risk. While MSA values can be volatile from period to period, there are many credit unions that have the ability to value and manage the risk inherent to the portfolio. Therefore, Desert Schools contends that the 250% threshold is excessive.

Recommendation

The risk-weight assigned to MSAs should be lowered to 100%. While there may be credit unions that don't have the sophistication necessary to manage the interest rate risk of MSAs, it is not appropriate to penalize those that have expended the resources to understand and invested the capital in risk management of these assets. Exam procedures should be put in place to mitigate MSA risk in excess of 100% risk-weight.

<u>Sections 702.104(d)(1) and (2) Due Diligence Requirements for Asset-Backed Securities:</u>

In its Section-by-Section Analysis, the NCUA states "Proposed § 702.104(d)(1) would provide that if a credit union is unable to demonstrate a comprehensive understanding, as required under proposed § 702.104(d)(2), of the features of an asset-backed investment exposure that would materially affect the performance of the exposure, the credit union must assign a 1,250 percent risk-weight to the asset-backed investment exposure. The proposed rule would also require that the credit union's analysis be commensurate with the complexity of the asset-backed investment and the materiality of the position in relation to regulatory capital according to this part."

Further, the NCUA states "Proposed § 702.104(d)(2) would provide that a credit union must demonstrate its comprehensive understanding of each asset-backed investment exposure under § 702.104(d)(1) by:

- Conducting an analysis of the risk characteristics of an investment's exposure prior to acquiring the investment and documenting such analysis within three business days after acquiring the exposure, considering:
    - Structural features of the investment that would materially impact the performance of the exposure, for example, the contractual cash flow waterfall, waterfall-related triggers, credit enhancements, liquidity enhancements, fair value triggers, the performance of organizations that service the position, and deal-specific definitions of default;
    - Relevant information regarding the performance of the underlying credit exposure(s), for example, the percentage of loans 30, 60, and 90 days past due; default rates; prepayment rates; loans in foreclosure; property types; occupancy;

average credit score or other measures of creditworthiness; average loan-to-value ratio; and industry and geographic diversification data on the underlying exposure(s);
  - Relevant market data of the asset-backed investment, for example, bid-ask spreads, most recent sales price and historical price volatility, trading volume, implied market rating, and size, depth, and concentration level of the market for the investment; and
  - For reinvestment exposures, performance information on the underlying investment exposures, for example, the issuer name and credit quality, and the characteristics and performance of the exposures underlying the investment exposures; and
- On an ongoing basis (no less frequently than quarterly), evaluating, reviewing, and updating as appropriate the analysis required under this section for each investment exposure."

Desert Schools interprets this part of the Proposed Rule to relate to private-label asset-backed investments; however, there is no definition within the Proposed Rule for an "asset-backed investment". In hindsight, this would make perfect sense for the 'synthetic', private label structures that were created and ultimately helped exacerbate the housing crisis during the recent economic downturn. On the other hand, a risk-weight of 1250% does not make sense for an agency mortgage-backed security in which an investor has never lost a dollar of principal. While an agency mortgage-backed security could have substantial interest rate risk, it would never be enough to substantiate a 1250% risk-weight.

Without a doubt a credit union should have a comprehensive understanding of each investment that it purchases. Similar to individual minimum capital ratios, Desert Schools is concerned with consistent and fair application of such a punitive risk-weight (1250%). For example, an examiner who dislikes certain agency mortgage-backed structures could invoke this provision to require a 1250% reserve rather than the standard 150% risk-weighting.

Recommendation

Desert Schools' initial recommendation is to eliminate these two sections from the Proposed Rule. The term "asset-backed investment" is vague and could be easily misapplied by examiners. Further, the inability for examiners to fairly and consistently apply such a vague rule could be devastating given the ramifications of a 1250% risk-weight. A perfect example of this would be for an examiner to try to apply this to an agency mortgage-backed security.

In the alternative, if elimination of these sections is not a viable option, the NCUA should take the steps to clearly define asset-backed investments to mean private label mortgage-backed securities.

<u>Section 702.105 Individual Minimum Capital Ratios:</u>

In its discussion of Section 702.105, the NCUA provides "This proposed rule includes a provision that NCUA may require higher minimum risk-based capital ratio for an individual credit union in any case where the circumstances, such as the level of risk of a particular investment portfolio, the risk management systems, or other information, indicate that a higher minimum risk-based capital requirement is appropriate. For example, higher capital may be appropriate for a credit union that has significant exposure to declines in the economic value of its capital due to changes in interest rates. Part 747 would contain procedures for requiring a credit union to maintain a higher minimum capital."

Section 702.105 is a very troubling section of the Rule given the application of a subjective standard for requiring minimum capital levels higher than the risk-based capital requirements. It would be almost impossible to implement this section in a fair and consistent manner across all regions and between each and every examination team. The industry has witnessed widely varying views between individual examiners on credit risk and interest rate risk. It would be difficult to preserve comparability and fairness when a strong "human element" is introduced in the evaluation process. Therefore, there is great potential for inconsistent methodology across the NCUA.

Section 702.108 Risk Mitigation Credit is being eliminated by the NCUA with the following appearing in the discussion of the Rule, "The review of a credit union's application for a risk mitigation credit requires a substantial commitment of NCUA and credit union resources. In practice, it is very difficult to determine the validity of the credit union's mitigation efforts and how much mitigation credit to allow."

Given the statement from the NCUA in the previous paragraph as well as their decision to eliminate Section 702.108, it would seem counter to try to implement individual minimum capital ratios. In fact, in practice it would seem to be more difficult to determine individual minimum capital ratios than it would to review and assess validity of a credit union's mitigation efforts.

Recommendation

Eliminate Individual Minimum Capital Ratios from the Rule so that consistency and fairness can be maintained.

<u>Section 702.106 Prompt Corrective Action for Adequately Capitalized Credit Unions:</u>

As proposed, prompt corrective action is required if a credit union were to fall below well capitalized status which is in contrast to Basel, which places limitations on banks if they fall below adequately capitalized. This is another example of the hurdle rate being higher for credit unions and further placing us at a strategic disadvantage.

Recommendation

Remove prompt corrective action for credit unions that are adequately capitalized.

OTHER AREAS OF CONCERN

Supplemental Capital

A credit union's net worth ratio is currently determined solely on the basis of retained earnings as a percentage of total assets. Because retained earnings often cannot keep pace with asset growth, otherwise healthy growth - such as growth resulting from taking deposits – can dilute a credit union's regulatory capital ratio. Allowing eligible credit unions access to supplemental capital, in addition to retained earning sources, will help ensure healthy credit unions can achieve manageable asset growth and continue to serve their member-owners efficiently. The increased capital burden under this proposal heightens the need for supplementary capital.

Recommendation

Desert Schools requests that NCUA actively supports legislation to allow federal credit unions to receive payments on uninsured, non-share capital accounts provided the accounts:

- *Do not alter the cooperative nature of the credit union;*
- *Are uninsured;*
- *Are subordinate to all other claims against the credit union, including the claims of creditors, shareholders, and the NCUSIF;*
- *Are available to be applied to cover operating losses of the credit union in excess of its retained earnings and, to the extent supplied, will not be replenished;*
- *Are subject to maturity limits as determined by the NCUA; and*
- *Are offered by a credit union that has been determined sufficiently well capitalized by the NCUA.*

Effective Date

The proposed effective date of approximately 18 months after publication of the final rule in the Federal Register falls well short of the time needed for credit unions to adjust to this major change. Credit unions will need ample time to adjust their asset mix and overall strategies to reflect the requirements/limitations of this proposal. This process should be done over a period of time that does not hinder credit unions' ability to maintain and earn additional capital. Please remember that credit unions are severely constricted in their ability to raise additional capital as compared to banks.

The NCUA states in their analysis of the Rule "The proposed 10.5 percent risk-based capital ratio target is comparable to the Other Federal Banking Regulatory Agencies' 8 percent Total Risk-based Capital ratio plus the 2.5 percent capital conservation buffer which is expected to be fully implemented in 2019. NCUA is proposing the 10.5 percent risk-based capital ratio requirement, rather than the Other Federal Banking Regulatory Agencies' 8 percent, to avoid the complexity of implementing a capital conservation buffer."

The following summarizes the time table for banks to be fully compliant with the 2.5% capital buffer under Basel:

- 2016 – 0.625% or 8.625% risk-based capital
- 2017 – 1.25% or 9.25% risk-based capital
- 2018 – 1.875% or 9.875% risk-based capital
- 2019 – 2.50% or 10.50% risk-based capital

Recommendation

Provide at least a four-year transition/implementation period after publication of the final rule to allow credit unions ample time to transition their asset mix and give them time to earn additional income to support the new capital requirement. Similar to the implementation period given to banks, this transition period could include periodic steps for compliance. Once again, without the transition period, credit unions would be at a competitive disadvantage to banks.

CONCLUSION

As previously stated, the NCUA's attempt to create a risk-based capital standard is a step in the right direction. However, the Proposed Rule as written would have severe capital consequences to credit unions and place them at a substantial competitive disadvantage to banks. If the Proposed Rule is implemented as it currently stands, credit unions may out of self-preservation seek bank charters where risk-based capital requirements are much more consistent in their treatment of asset classes and much less punitive. The recommendations contained in this comment letter would improve the Proposed Rule and allow credit unions to confidently operate under this new standard. These recommendations would also give the NCUA peace of mind that credit unions have sufficient capital to operate in a safe and sound manner and provide competitive products to their members in comparison to banks.

Thank you for the opportunity to comment on the Proposed Rule and for considering our opinions on the risk-based capital requirements.

Sincerely,

Susan C. Frank
President and Chief Executive Officer
Desert Schools Federal Credit Union